benefits. A proposal to include the value of HI coverage in excess of an individual's contributions and to tax the insurance value of SMI benefits in AGI is discussed elsewhere (see ENT-09). Revenue gains from including benefits from means-tested programs, such as Aid to Families with Dependent Children, in AGI would be small because few people who qualify for means-tested programs would have enough income to incur any federal income tax liability.

Increase the Taxation of Social Security and Tier I Railroad Retirement Benefits. Under current law, AGI includes the lesser of one-half of Social Security and Tier I Railroad Retirement benefits or one-half the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount is $25,000 for single returns and $32,000 for joint returns.

Social Security benefits can be viewed as being analogous to private pensions because they are based on past earnings. Taxation of 50 percent of benefits would make the tax treatment roughly comparable over a worker's lifetime to the tax treatment of noncontributory pensions. Taxation of 85 percent of benefits would be roughly comparable to the tax treatment of contributory pensions for those with the lowest rate of return in Social Security and more favorable than the tax treatment of contributory pensions for other beneficiaries.

Eliminating the threshold (whether 50 percent or 85 percent of benefits are included in adjusted gross income) would have several advantages. First, it would make the taxation of these benefits more consistent with the taxation of other pension benefits, thereby strengthening the pension or deferred compensation logic of the program. Second, taxing benefits for all would reduce work or saving disincentives now facing beneficiaries near the threshold. Third, the complicated calculations under current law involving thresholds would be eliminated, thus simplifying tax compliance and administration.

On the other hand, reducing the current after-tax level of Social Security benefits would lower the standard of living of many of today's elderly people. This would be regarded by many as a violation of a social contract. Moreover, because Social Security constitutes a larger fraction of the retirement income of middle-income elderly and disabled people than of upper-income retirees, taxing their benefits at even a relatively low marginal tax rate would have a greater effect on their after-tax disposable income than it would on those higher in the income distribution. (Because of personal exemptions, including the extra exemption for those 65 and over, very-low-income people would remain tax-exempt even if all Social Security benefits were included in AGI.) If benefit levels were increased to offset this tax policy change, however, the budget deficit would not be reduced.

Alternatively, thresholds of $12,000 for single returns and $18,000 for joint returns could be set so that the taxation of benefits did not affect current beneficiaries in the lower portion of the income distribution. These thresholds would decrease the five-year revenue gain from about $35 billion to $14 billion if 50 percent of benefits were included in AGI, and from about $84 billion to $37 billion if 85 percent of benefits were included in AGI. As has happened with the thresholds under current law, inflation would slowly erode the value of these new thresholds and gradually move the result toward full taxation of 50 percent or 85 percent of benefits.[1/]

Tax All Unemployment Insurance Benefits. Under current law, taxpayers must include unemployment insurance compensation in AGI using a graduated formula if their income exceeds thresholds of $18,000 for joint filers and $12,000 for single filers. Taxing all unemployment benefits would add $3.5 billion to revenues in 1987 through 1991. This provision was included in the President's tax reform proposal and in H.R. 3838.

The argument for including all unemployment insurance benefits in income is that doing so would tax these benefits the same way as the wages they replace, thereby making net unemployment insurance benefits received by any individual worker dependent on the total income of the family unit and reducing the work disincentives that these benefits may create. Opponents argue that inclusion of all benefits in AGI would impose a heavier burden on people who have suffered a large decline in income.

Tax Workers' Compensation and Black Lung Benefits. Workers' compensation benefits reimburse employees for medical costs and lost income resulting from work-related injuries. Black Lung benefits reimburse disabled coal miners who have pneumoneucleosis for medical costs and lost income. None of these benefits are taxable under current law. Including the income maintenance portion of these benefits in AGI would make their tax treatment consistent with that of other forms of income and would

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1. See CBO, *An Analysis of Selected Deficit Reduction Options Affecting the Elderly and Disabled* (March 1985) and *An Analysis for Taxing Social Security as a Private Pension*(June 1985), for more detailed discussions of options for increasing taxation of Social Security benefits.

reduce work disincentives for disabled workers. Seventy-five percent of workers' compensation benefits cover income loss, and the remaining 25 percent cover medical costs. In some cases, the after-tax value of wages for those able to return to work is less than their tax-free benefits. Taxing the income maintenance portion of workers' compensation benefits and Black Lung benefits would add $14 billion to revenues in 1987 through 1991.

Opponents argue that damages for non-work-related injuries are not subject to tax, even though a portion of the damages reimburses for income loss, and that taxation of workers' compensation benefits would treat these two types of compensation inconsistently. They also argue that taxation of benefits would not significantly increase the incentive to work.

REV-28 ELIMINATE EXTRA TAX EXEMPTION FOR THE ELDERLY AND THE BLIND

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	1.7	3.5	3.8	4.3	4.6	17.9

Any taxpayer at least 65 years old or blind is permitted to claim an extra personal exemption. For tax year 1985, the personal exemption is $1,040; as a result of indexing, the personal exemption will be $1,080 for 1986. The most widely perceived reasons for these provisions are the lower income and extra costs of living (especially medical costs) of the elderly and the blind. Repeal of the extra exemption would increase revenues by $1.7 billion in 1987 and by about $18 billion between 1987 and 1991. Most of the revenue gain (98 percent) would be paid by the elderly.

The extra exemption is criticized on several grounds. First, neither age nor blindness is a particularly accurate indicator of financial need. In 1983, 43 percent of all extra exemptions for age and 40 percent of those for blindness were claimed by taxpayers with adjusted gross incomes above the median income. The poorest of the elderly and the blind--those whose incomes are so low that they do not file tax returns--do not benefit from the extra exemption at all. In 1983, 14.8 million exemptions were claimed out of an estimated 27.4 million elderly persons. Moreover, taxpayers with high incomes face higher marginal tax rates. Thus, the exemption gives them greater relief from tax than those with lower incomes.

Second, any elderly or blind taxpayer with extraordinary medical bills can deduct them from adjusted gross income. The extra exemption is neither needed to offset such expenses nor related to the size of a taxpayer's medical bills.

Third, the extra exemption was adopted in 1959 when Social Security benefits were low and the incidence of poverty among the elderly (35.2 percent) was much higher than among the population in general (22.4 percent). In 1984, largely because of Social Security, only 12.4 percent of the elderly were in poverty compared with 14.4 percent for all persons. Although some Social Security benefits are now partially taxed, benefits of taxpayers with modified adjusted gross incomes of less than $32,000 for joint returns ($25,000 for single returns) are not taxed.

Finally, the current tax law also provides a special credit for the elderly and the handicapped. A maximum credit of $750 ($1,125 for taxpayers filing joint returns) is available to elderly and disabled taxpayers who do not receive substantial amounts of tax-exempt pension income (including Social Security).

Proponents of retaining the exemption contend that it should be evaluated in the context of the overall benefits and tax advantages afforded the elderly. Social Security benefits are weighted in favor of those with low lifetime incomes and are taxable only for taxpayers with sufficient other income. The tax credit for the elderly is not available to taxpayers with incomes above certain thresholds. Eliminating the extra exemption would disrupt the redistributive balance in the existing package of entitlements and taxes.

If the Congress wished to protect needy taxpayers from the higher taxes resulting from repeal of the extra exemption, however, the present credit for the elderly and the disabled could be expanded. Raising the maximum credit by $150 ($300 for joint returns) would compensate most elderly taxpayers with up to average amounts of tax-exempt Social Security benefits for the elimination of the extra personal exemption. This increase in the credit would reduce the revenue pickup by only $0.6 billion in the years 1987 through 1991.

REV-29 DISALLOW INCOME AVERAGING FOR FORMER STUDENTS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.1	0.5	0.6	0.6	0.7	2.5

Under current law, income averaging is available to taxpayers whose incomes fluctuate greatly from one year to the next, or whose incomes rise dramatically in a given year. Such a taxpayer would have a higher tax liability over a period of several years than another taxpayer with the same total income, but a more even year-to-year pattern of earnings. This occurs because of the progressive rate structure and the arbitrary selection of one year as the appropriate accounting period for income measurement and taxation. Higher taxation of those with greater fluctuations of income is difficult to justify on grounds of fairness. As a result, income averaging was enacted in 1964 to reduce tax liabilities on fluctuating income in high-income years.

Income averaging allows a lower marginal tax rate to apply to a portion of the current year's income than would apply under the regular tax rate schedules. From 1969 to 1983, a taxpayer was eligible for income averaging if his or her current year's income exceeded by $3,000 or more 120 percent of his average taxable income in the previous four years (the "base period"). In 1969, 0.9 percent of all tax returns used the averaging formula to compute tax liability. By 1983, the portion had risen to 5.6 percent. Because the Congress believed that much of this increase occurred simply because inflation drove up nominal incomes, it tightened the averaging rules in the Deficit Reduction Act of 1984. Under present law, a taxpayer's current-year income must exceed by $3,000 or more 140 percent of his average income over the previous three years. This is expected to reduce the averaging population by about a third.

Income averaging has always been intended to provide relief to taxpayers who are self-supporting. Under current rules, however, some taxpayers who were not fully self-supporting during the base period can use the averaging method of tax computation. This problem could be reduced by disallowing income averaging for former students. Recent proposals would disallow it for any taxpayer who had been a full-time student during any of the three years of the base period. This restriction would not apply to married people whose current-year income contributed 25 percent or less to joint current-year income.

Proponents of this change argue that income averaging should be available only for those with unpredictable or uncontrollable fluctuations in income. In contrast, the sharp increase in incomes of former students entering the job market is predictable and intentional. Additionally, it is believed that this change would reduce complexity. The need to maintain records for several consecutive years and to prove one's self-supporting status has been burdensome for some taxpayers and has caused disputes between taxpayers and the Internal Revenue Service.

Tax reform proposals that lower and flatten marginal tax rates reduce the rationale for any income averaging. Both the President's tax reform proposal and H.R. 3838 would eliminate income averaging entirely. Under the current tax rate structure, however, strong equity arguments for some form of income averaging remain.

REV-30 IMPROVE TAX COMPLIANCE AND ENFORCEMENT

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1987	1988	1989	1990	1991	Cumulative Five-Year Addition
Increase IRS Audit Coverage a/	0.3	0.6	0.8	0.9	1.0	3.6
Increase Penalties for Failure to Comply with Tax Laws	0.4	0.4	0.4	0.4	0.4	1.9

a. Net of increased outlays.

Compliance with the tax laws appears to have declined significantly during the 1970s. The Internal Revenue Service (IRS) estimates that about $91 billion in taxes owed went unpaid in 1981, a nearly threefold increase over 1973 (or a 58 percent increase after adjusting for inflation). Since 1981, however, marginal tax rates have been lowered by 23 percent, and a number of provisions have been enacted to improve the reporting of income. Thus, although noncompliance remains a severe problem and no current data or estimates are available, it is likely that the gap between taxes owed and taxes paid (the "tax gap") has declined since 1981.

Although illegal activities are responsible for part of the tax gap, the IRS estimates that 90 percent of the revenue shortfall is the result of false reporting of taxable income from legal activities. Income underreported by individuals was estimated to account for 58 percent of the tax gap--about $52 billion in 1981. Overstated expenses, deductions, and credits accounted for $13 billion; failure to file returns for $3 billion; and underpayments for about $7 billion. Corporations were responsible for only $6 billion or 6.9 percent of the tax gap.

Increase IRS Audit Coverage. One way to improve compliance is to increase the probability that a taxpayer will be audited. The number of examiners and the data processing capacity at the IRS have not kept pace with either the increased work load or the increasing complexity of the tax code. Audit coverage has fallen from 2.6 percent of all returns in 1976 to 1.3 percent in 1985. Adding new IRS staff could bring an immediate and large payoff in revenues--estimated to be about $16 for each additional dollar spent if the increased number of auditors are assigned only to high-income returns. A permanent increase in staff of 1,550 examiners beginning October 1, 1986, would raise about $0.3 billion in 1987 and $3.9 billion over the 1987-1991 period. These additional revenues would be partly offset by about $0.2 billion in 1987-1991 outlays for additional staffing and other resources. This increased audit coverage, however, would impose additional compliance burdens on all taxpayers--including honest ones.

The President's budget would add approximately 2,500 employees each year to the examination staff between 1987 and 1989, for a total increase of 7,500 employees. This is estimated to increase revenues by $10.4 billion between 1987 and 1991, with an offsetting increase in staffing costs of $1.3 billion.

<u>Increase Penalties for Failure to Comply with Tax Laws</u>. An alternative way of improving compliance is to increase penalties for failure to pay taxes and for supplying incorrect information to the IRS. Possible changes include increasing the penalty for taxpayers failing to pay taxes when due from 0.5 percent to 1.0 percent of the underpayment per month for every month after the IRS must switch to more expensive collection methods; increasing the maximum penalty for failure by income sources to file information returns or to supply a copy to the taxpayer from $50,000 to $100,000; and increasing the penalty on underpayments in cases of taxpayer fraud from 50 percent to 75 percent, while narrowing the base on which the penalty is imposed to include only the portion of the underpayment directly attributable to fraud.

H.R. 3838 includes these and other changes in the penalty structure. It is estimated that the increased penalties in H.R. 3838 would increase revenues by $0.4 billion in 1987 and by about $2 billion in 1987 through 1991.

The proposed increases can be justified as making penalties more closely correspond to the average cost of collecting delinquent taxes, although the costs and penalties would not be closely matched for any given taxpayer. In addition, in the case of fraud, narrowing the base would make the penalty correspond more closely to the fraudulent behavior. While these modifications in the penalty structure would increase revenues, it is not clear that they would significantly improve voluntary tax compliance. Increased collections from those who failed to comply, however, might be regarded as desirable even if total compliance was not significantly affected.

The President's budget would replace existing penalties with charges based on the cost of collecting overdue tax payments, for an increase in revenues of $0.3 billion in 1987 and about $1.8 billion in 1987 through 1991.

REV-31 REDUCE TAX PREFERENCES ACROSS THE BOARD

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	9	37	44	50	57	197

Significant revenue could be raised by reducing tax preferences. Tax preferences are the deductions, exclusions, and credits that reduce the tax payments of selected persons and businesses; they do not include deductions for valid costs of doing business. Elimination of tax preferences on an item-by-item basis might be very difficult because groups who would lose tax benefits strongly oppose such changes. An across-the-board partial reduction in preferences might be politically more feasible since it would not single out specific groups of taxpayers for large tax increases. Preference reductions would complement the across-the-board reductions in direct federal expenditures that may occur under provisions of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). Proposals to reduce preferences are generally offered as alternatives to tax rate increases as a way of raising federal revenues.

One proposal to reduce tax preferences calls for a 10 percent cut in itemized (personal) deductions and a 20 percent reduction in most credits, exclusions, and other deductions that are regarded as tax preferences for both individuals and corporations. The proposal would also lengthen depreciation lives by 20 percent, tighten limits that apply to some tax preferences by the same percentage, and increase the tax rate of the alternative minimum tax on individuals from 20 percent to 26 percent. It would raise an estimated $197 billion in revenues during the 1987-1991 period. To the extent that tax reform would reduce or eliminate tax preferences, less revenue could be raised by scaling back remaining preferences.

A variant of this proposal would use 15 percent when scaling back all preferences, and would increase the alternative minimum tax rate to 24.5 percent. This version of the proposal would raise less revenue overall, about $186 billion from 1987 through 1991, with a larger share of revenues raised from individuals who itemize deductions and a smaller share from other individuals and corporate and noncorporate businesses.

An across-the-board reduction in preferences would in general raise more revenue from those taxpayers currently receiving relatively larger total tax benefits, in contrast to an income tax surtax that would raise the most revenues from those already paying the most in taxes. As a result, it would reduce differences in taxes paid by taxpayers with similar incomes who make different use of tax preferences, and would make after-tax returns to different economic activities more equal. Consequently, a uniform reduction in preferences would probably increase fairness and involve a smaller loss in efficiency than would higher statutory tax rates that raised equal revenues.

Cutting preferences across the board might reduce preferences that arguably promote legitimate public objectives, such as encouraging charitable giving. Equal percentage cuts in preferences might have unequal effects on economic incentives since, for example, a 10 percent reduction in a credit will have a larger after-tax effect on incentives than a 10 percent cut in a deduction. Finally, it is sometimes arguable whether a deduction, credit, or exclusion is a subsidy to some taxpayers or activities, or is a correction for problems of properly measuring income and therefore not actually a tax preference.

REV-32 EXPAND MINIMUM TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Expand Existing Individual Alternative Minimum Tax						
Option I						
At 20 percent	0.1	0.3	0.3	0.3	0.4	1.1
At 25 percent	1.4	7.1	8.7	10.7	13.2	41.1
Option II						
At 25 percent	0.9	5.0	6.0	5.5	4.9	22.3
Expand Base of Present Corporate Add-on Minimum Tax						
At 15 percent	1.0	3.3	5.4	8.5	13.4	31.7
At 20 percent	1.4	4.6	7.3	11.6	18.1	43.0
Replace Add-on Corporate Tax with a Broad-Based Alternative Minimum Tax						
At 15 percent	0.7	1.4	2.0	2.9	4.3	11.3
At 20 percent	1.1	2.2	3.2	4.6	6.7	17.8
At 25 percent	2.1	4.1	5.4	7.2	9.6	28.4

Under current law, individual taxpayers who make extensive use of certain preferences may be subject to a 20 percent alternative minimum tax (AMT) on an alternative tax base that includes those preferences. Alternative minimum taxable income (AMTI) is calculated by adding specified preferences to adjusted gross income (AGI), subtracting specified itemized deductions, and then subtracting an AMT exemption of $40,000 for a joint return, $30,000 for a single or head-of-household return, or $20,000 for married couples filing separately. Also, under current law, a corporation that makes extensive use of tax preferences may be subject to an add-on minimum tax equal to 15 percent of the difference between the total of certain tax preferences and the greater of either $10,000 or its regular income tax liability.

These minimum taxes could be expanded by including more items in the lists of preferences subject to the taxes. The revenue gain would depend on the rate and on the number and size of preferences included. Another option is to replace the present additional tax on corporate tax preferences with an alternative minimum tax on an expanded income base. Again, the revenue effect would depend on how much the base was expanded, with the greatest revenue gain expected from a minimum tax on economic income.

Expand Existing Individual AMT. This discussion of the individual AMT includes two options. The first option would slightly reduce the AMT exemption compared with present law and expand the list of minimum tax preferences, for instance by including all accelerated depreciation on new investment in AMTI instead of only the portion included under current law. (For the minimum taxes shown here, the accelerated depreciation preference is defined as the difference between ACRS depreciation and straight-line depreciation over ADR midpoint lives for machinery and equipment and 40 years for structures.) The one completely new preference added to AMTI under the first option would be any appreciation in the value of property donated to charity that had not been included in AGI.

The second option would include all the changes in the first option plus three new preferences: interest on newly issued tax-exempt non-governmental obligations (excluding refundings of pre-1987 bonds); deductions under the completed contract method of accounting in excess of the percentage of completion method; and net business losses that are deductible under the regular tax, but are associated with activities in which the taxpayer was a passive investor. It would substitute for the present provision, which allows incentive credits that do not benefit the taxpayer because of the minimum tax to be carried over against the regular tax, a more liberal provision that any minimum tax paid be carried over as a credit against future regular taxes. Because taxpayers switch back and forth between the AMT and the regular tax, this change in credit provisions would leave many with lower total tax liabilities than under present law. For this reason, Option II has a significantly smaller revenue gain than the 25 percent AMT in Option I, even though it has a broader base.

The individual minimum tax included in the President's tax reform proposal is similar to the 20 percent Option I minimum tax discussed here, and the proposal in H.R. 3838 is similar to the Option II minimum tax. In both tax reform proposals, the revenue effect of an alternative minimum tax is different than reported above, because it is combined with other major tax changes.

Expand Base of Present Corporate Add-on Tax. At the current 15 percent rate, a very broad expansion of the present add-on corporate minimum tax could add as much as $32 billion to revenues over the 1987-1991 period. At a higher rate on the same expanded base, the additional revenue raised by an add-on minimum tax would be roughly proportional to the increase in the rate.

Replace Add-on Corporate Tax with an AMT. Another option would be to replace the add-on corporate minimum tax with a broad-based corporate AMT. At 15 percent, a corporate AMT with approximately the same base as the expanded add-on tax discussed above, and with an exclusion of $40,000, would increase revenues by about $11 billion between 1987 and 1991. A broad-based corporate AMT with a 25 percent rate, which would be similar to the corporate AMT in H.R. 3838, would raise about $28 billion over the same period.

Incentive tax credits are not allowed against either of the corporate minimum taxes discussed above. In order to avoid double taxation of corporations that pay the AMT only in some years, however, under the corporate AMT proposal any AMT paid would be carried over to future years as a credit against regular tax liability. This provision limits the growth of net revenue from the AMT, because corporations that trigger off the AMT by becoming liable for the regular tax can quickly recover what they had paid under the AMT. This contributes to the smaller revenue gain from an AMT compared to the add-on minimum tax, and also to the slower growth in revenue from an AMT.

A minimum tax reduces the ability of individuals and corporations with economic income to escape income tax completely, or to shelter major portions of their income from taxation. At the same time, it reduces the value of incentives that were enacted to promote activities that the Congress felt should be encouraged. Also, a minimum tax increases the complexity of the tax system: under some circumstances, an AMT could hit some taxpayers harder than intended, or cause them to engage in more tax-motivated behavior than the incentives it reduced. An AMT would be especially disruptive to corporate planning because its impact on the value of any particular incentive would depend on the timing and mix of all the incentives used by the corporation, and because the tax could be triggered on and off frequently. On the other hand, only taxpayers with incomes above the exclusion and regular effective tax rates below the AMT rate would be affected by the AMT.

As with all the revenue estimates in this report, the significant revenue increases shown for these broad-based minimum taxes are estimated on the assumption that no other changes would be made in current law. Any general tax reform that restricted preferences would reduce the additional revenue to be gained from a minimum tax. As long as preferences were not completely eliminated, however, a minimum tax might still be a significant revenue source.

If an increase in the total level of taxes paid by corporations and high-income individuals became a general goal of public policy, a broad-based minimum tax would be more neutral than a surtax on tax liability or an increase in the general rate. It would be more complex, however, and less neutral, than direct measures to broaden the regular tax base, including some--such as a broad scaling back of preferences (see REV-31)--that would have many of the positive attributes of a minimum tax. An add-on minimum would probably cause less economic distortion, and might raise revenue more efficiently than an AMT, but would not as directly promote the objective of affecting only corporations and individuals that received significant economic income and paid little or no tax.

REV-33 REPEAL THE POSSESSIONS TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	1.1	1.9	2.1	2.3	2.6	10.0

Income earned by U.S. corporations operating in Puerto Rico or U.S. possessions is generally treated as foreign-source income, and the federal tax on such income is offset by the foreign tax credit (FTC) for any tax paid to the possession. Use of the FTC would prevent such income from being subject to income tax in both the United States and the possession. In order to promote employment, however, current law provides a more generous treatment for certain business and qualified investment income from Puerto Rico and U.S. possessions; this can have the effect of exempting such income from being taxed by either government. A corporation that received at least 80 percent of its gross income for the last three years from sources within Puerto Rico or any U.S. possession other than the Virgin Islands (at least 65 percent from the active conduct of a trade or business) may claim a possessions tax credit instead of the FTC. (Income from the Virgin Islands is treated similarly, but under a different tax provision.) The possessions tax credit is equal to the U.S. tax on the qualified possessions source income, and can be claimed even if no tax was paid to the possession.

The principal argument for repeal is that use of this incentive has provided significant tax benefits to certain businesses, especially pharmaceutical manufacturers, without correspondingly significant increases in employment in U.S. possessions. Despite very complex limitations enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the primary incentive provided by the credit is to allocate to possessions the income from intangible assets developed in the United States. Opponents argue that the incentive is needed to promote investment and employment.

The President's tax reform proposal suggests replacing the possessions tax credit with a wage credit on the grounds that the latter would be a more efficient employment incentive. H.R. 3838 would tighten the rules and restrictions governing the use of the possessions tax credit, but would have little effect on the revenue loss from the credit.

REV-34 PLACE A PER-COUNTRY LIMIT ON THE FOREIGN TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	0.8	2.0	2.3	2.6	2.9	10.6

Under present law, U.S. taxpayers are allowed a credit for foreign income taxes paid. The credit is limited to the amount of U.S. tax that would otherwise be owed on the foreign-source income. This limit is intended to prevent use of the foreign tax credit to offset foreign tax rates higher than the U.S. rate. The limitation applies to the overall total of foreign taxes, rather than applying separately to taxes paid on income from each country. As a result, a taxpayer with investments in a country with a tax rate higher than the U.S. rate can reduce tax payments by also investing in a foreign country with a low tax rate. The foreign tax credit from the high-tax country can then be used to reduce U.S. taxes on income from the low-tax country.

If the foreign tax credit was computed on a per-country basis, taxpayers with excess foreign tax credits from investments in high-tax countries would no longer be able to reduce their total tax burdens by shifting investment from the United States to low-tax countries. This proposal would prevent the foreign tax credit from distorting investment decisions, but it would be difficult to enforce because foreign taxes and income sources would have to be matched explicitly. Foreign subsidiaries operating in more than one country would have strong incentives to shift reported income between high- and low-tax countries in order to circumvent the per country limitation.

A per-country limitation on the foreign tax credit would add about $11 billion to federal revenues between 1987 and 1991. The President's tax reform proposal includes a per-country limitation. H.R. 3838 would impose separate limits on credits associated with four categories of income: high-tax, low-tax, financial, and shipping.

REV-35 TAX CAPITAL GAINS AT DEATH

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1987	1988	1989	1990	1991	
Addition to CBO Baseline	a/	4.6	4.9	5.3	5.6	20.4

a. Less than $50 million.

Realized capital gains are taxed as income. An exception occurs when a person sells an inherited asset. Only the gain since the date of inheritance is taxable. (The full value of the inheritance may have been taxed, however, under the separate estate and gift transfer tax if the inheritance was large enough.) The income tax exception could be removed either by taxing capital gains on the decedent's final income tax return, or by requiring the beneficiary to carry forward the decedent's cost basis (generally the original purchase price, less any adjustments). Taxation of gains at death would raise about $20 billion from 1987 through 1991.

Taxation of capital gains at death would reduce opportunities for wealthy families to avoid tax permanently on an important source of their income.. In addition, it would reduce the bias in current law that favors investments in assets that appreciate in value over investments in assets that pay regular cash returns. An advantage for appreciating assets would continue, however, both because of the continued exclusion from tax of 60 percent of long-term capital gains and because of the continued deferral of tax on accrued capital gains income until death. Another benefit of taxation of gains at death is that it would reduce the "lock-in" effect of the current capital gains tax; taxpayers could not avoid capital gains taxes permanently by holding onto appreciated assets rather than selling them. Finally, the recent lowering of estate taxes has made it more important to ensure that income accumulated within a person's lifetime not escape tax when assets are transferred at death.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and that in some cases, such as small farms or businesses, it could force an estate to liquidate assets in order to pay the tax. The forced sale problem could be reduced by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, the heir could be made to carry forward the decedent's cost basis (carryover basis). This would avoid the liquidity problem mentioned above. Critics have argued that carryover basis would create serious recordkeeping problems because heirs would need to know the prices paid by the decedent for assets purchased many years before to compute their tax liability when they came to sell them. Compared to taxation at death, the carryover basis allows a continued tax deferral on the unrealized gain.

In the Tax Reform Act of 1976, the Congress enacted carryover basis for assets transferred at death, but this provision never took effect and was repealed in 1980. Neither carryover basis nor the taxation of gains at death is included in a major tax reform proposal.

As noted, in addition to imposing income tax liability on realized capital gains, the federal government imposes an estate and gift transfer tax on capital assets when the inheritance is large enough. The Economic Recovery Tax Act of 1981 enacted gradual increases in the exemption below which estates do not pay taxes. In 1985, the exemption was $400,000; it will increase to $500,000 in 1986 and $600,000 in 1987. ERTA also legislated decreases in the maximum estate and gift tax rate. The last of these decreases will take place in 1988 (under a subsequent change enacted in 1984).

Some observers have suggested that if the income tax continues to excuse liability on unrealized capital gains at death, the estate and gift tax should be tightened to impose a greater transfer levy on those gains. One means to accomplish that end would be to freeze the estate tax exemption at the 1985 level of $400,000 and to freeze the current rate schedule. These changes would increase revenues by about $9 billion over the 1987-1991 period.